No. 12,386

IN THE

United States Court of Appeals

For the Ninth Circuit

TWIN OAKS COMPANY,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Brief for Petitioner

On Petition to Review a Decision of the Tax Court of the United States

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HERMAN PHLEGER,
THEODORE R. MEYER,
ALVIN J. ROCKWELL,
CARL E. DAVIDSON,
RALPH R. BAILEY,
Attorneys for Petitioner.

BROBECK, PHLEGER & HARRISON,
Of Counsel.

PARKER PRINTING COMPANY, 180 FIRST STREET, SAN FRANCISCO

SUBJECT INDEX

TABLE OF AUTHORITIES CITED

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JURISDICTION

This case brings on for review a decision of the Tax Court of the United States holding petitioner liable for deficiencies in the taxable years ending December 31, 1942, 1943 and 1944, as follows (R. 326):

Year	Income Tax	Declared Value Excess Profits Tax	Excess Profits Tax
1942	$1,394.61	$ 373.11	$ —
1943	3,120.38	3,778.43	11,311.08
1944	4,532.68	6,565.25	24,562.88

The Commissioner's notice of deficiency was mailed to petitioner on October 3, 1947 (R. 10), and the petition for redetermination was filed with the Tax Court on December 24, 1947 (R. 2). The Tax Court, therefore, had jurisdiction under Section 272(a)(1), Internal Revenue Code, 53 Stat. 82, as amended, 26 U.S.C. Section 272(a)(1).

The Tax Court entered its decision on July 18, 1949 (R. 4, 325). Petition for review of the decision by this Court was filed by petitioner on September 16, 1949 (R. 4, 327-331). Petitioner's tax returns for the years in question were filed with the Collector of Internal Revenue for the District of Oregon (R. 268; R. 257-258, Res. Exhs. L, M, N). Accordingly, this Court has jurisdiction under Sections 1141 and 1142, Internal Revenue Code, 53 Stat. 164, 165, as amended, 26 U.S.C. Sections 1141, 1142, *Ibid.*, Supp. II.

SUBSTANCE OF THE CONTROVERSY

The Commissioner of Internal Revenue has taxed Twin Oaks Company, a corporation (the petitioner here), on income earned by a partnership, which succeeded to the corporation's business. The years 1942, 1943 and 1944 are involved in the case; but in practice the present decision will presumably control the later years also.

The fundamental question is whether this income should be taxed to the partnership, which earned it, or whether the Commissioner was right when he taxed it to the petitioner corporation.

Twin Oaks Company, the petitioner, is an Oregon corporation, with its office at Eugene. It was incorporated in 1924 and until 1941 conducted a lumber and building supply business. It was not a large company, its total

assets never exceeding $151,000. The business was hardly profitable. During the six years from 1935-1940, it sustained operating losses in four and a net deficit in one, 1938. Its highest net income was $6,036.35 in 1940.

The company had 946 shares of $100 par value, a total of $94,600. Half were owned by John J. Rogers, who was the president, the other half by Louis C. Scharpf, the secretary-treasurer, and his wife, in the respective amounts of 35.3 and 437.7 shares. Rogers and Scharpf received salaries which at their highest were $7,200 each per annum, and ran the business.

In 1939 Scharpf suggested that the business be conducted as a partnership. Rogers demurred: he did not like the personal liability of a partner. But Scharpf persisted, and during 1940 they had a number of conferences with E. R. Bryson, the company's long-time attorney. The attorney finally recommended Scharpf's plan, and Rogers agreed on condition that the company continue to hold the real estate.

Accordingly, in January 1941, Rogers, Scharpf, and their wives entered into a partnership agreement, whereby all four were to conduct the business as equal partners with operating assets which they were to acquire from the Twin Oaks Company. Each made a capital contribution of $2,000 and they agreed to share profits and losses equally. Rogers and Scharpf, as partners, were to continue to head the business.

On January 2, 1941, the corporation accepted the offer of Rogers, Scharpf and their wives to acquire its current assets in consideration of their assumption of certain of its accounts and notes payable, and their note for the

balance; and agreed to lease them the premises and to discontinue its lumber and building supply business. The transfer was concluded in accordance with the offer and acceptance. Fair value was paid for the assets and a reasonable rental was provided in the lease.

Books for the partnership were opened and its own bank account established. The partners signed and filed a certificate showing that they were doing business under the assumed name of Twin Oaks Builders Supply Company, and published notice of this. The partnership filed a certificate with the State Industrial Accident Commission that it was engaging in a hazardous business, employing 25 people, with a monthly payroll of about $2,600. It registered with the State Unemployment Compensation Commission. The partnership did not draw financial or other support from the company or lean upon it in any way.

The partnership earned profits as follows:

1941	$29,776
1942	18,525
1943	42,086
1944	66,119

Partnership returns were duly filed and the partners returned their respective shares of the profits as income and paid their individual taxes. A note of $89,378.35 given by the partnership to the corporation as part of the consideration for the transfer of the business, together with interest, was paid in full in 1946.

The Commissioner, on October 3, 1947, mailed to the corporation a notice of deficiency asserting additional taxes against it as follows:

1942	$ 1,767
1943	18,209
1944	35,660
Total	$55,636

As a parting shot, the Commissioner claimed penalties of $8,967 for failure of the corporation to file excess profits tax returns. (The single Tax Court judge, who handled the case, refused to sustain the Commissioner as to the penalties, and they are no longer involved.)

All these taxes and penalties were asserted against the corporation on the claim that the partnership and the transfer from the corporation to it were without substance and should be disregarded. On this theory, the Commissioner treated the partnership income as that of the corporation and asserted taxes upon it accordingly.

The question, then, is a simple one: Can the Commissioner in the present circumstances treat as income of a corporation income which is earned by another entity, as it happens here, a partnership?

We assert that the evidence shows conclusively that a partnership was formed in good faith and in fact; that this partnership succeeded to the business and assets of the corporation; and that the income involved was earned by it, and can no more be treated as income of the corporation than can income of A be assessed to B.

We maintain that the power here asserted by the Commissioner if applied generally would mean that no corporation could be dissolved, and its business thereafter conducted by its stockholders, and no partnership could be incorporated into a corporation, without danger that the

Commissioner might arbitrarily levy taxes by ignoring the change in the legal status of the taxpayer.

We direct the Court's attention to three circumstances which are important to an understanding of the facts: 1. The transfer of the business from the corporation to the partnership was not made for any tax purpose; the prior earnings of the company were very slight; the excess profits tax was not even enacted until many months after Scharpf urged the change. 2. Since a *bona fide* transfer was made, and the partnership conducted the business and earned the income, a tax saving purpose, in any event, would have been immaterial. 3. This case does not involve any "family partnership" question—that is to say, the issue here is not one of taxing the wives' income to the husbands' but of taxing the income of all four partners *to the corporation.*

We now proceed to a full statement of the matter.

STATEMENT OF THE CASE

Questions Presented.

1. Whether, as held by the Tax Court, the Commissioner of Internal Revenue could lawfully impose upon petitioner, a corporation, income taxes, declared value excess profits taxes and excess profits taxes, with respect to the income of a separate legal entity, a partnership, derived from a business conducted by such partnership.

2. Only in the event that the foregoing question is answered in the affirmative will it be necessary to consider the further question:

Whether, after holding that the income of a partnership was to be attributed and taxed to petitioner, a corporation, the Tax Court, in computing the resulting de-

ficiency in excess profits taxes, could lawfully refuse to include, as part of the petitioner's invested capital, the invested capital and accumulated earnings and profits of the partnership.

Statutes Involved.

The classes of taxes here involved were imposed for the years 1942, 1943 and 1944 by: (1) Corporation normal income tax—Internal Revenue Code, Section 13, 53 Stat. 7, as amended through the Revenue Act of October 21, 1942; 26 U.S.C., 1940 ed., Sec. 13; *Ibid.,* Supp. II. (2) Surtax—Internal Revenue Code, Section 15, as amended by the Revenue Act of October 21, 1942, Title I, Section 105(b), 56 Stat. 805; 26 U.S.C., 1940 ed. Supp. II, Section 15. (3) Declared value excess profits tax—Internal Revenue Code, Section 600, 53 Stat. 111, as amended through the Revenue Act of October 21, 1942; 26 U.S.C., 1940 ed., Supp. II, Section 600. (4) Excess profits tax—Internal Revenue Code, Section 710, as amended by the Revenue Act of October 8, 1940, Title II, Section 201, 54 Stat. 975, and as thereafter amended through the Act of February 25, 1944; 26 U.S.C., 1940 ed., Section 710; *Ibid.,* Supp. II; *Ibid.,* Supp. IV.

The scheme of these sections, as shown in Section 13(b) of the Internal Revenue Code, *supra,* with respect to the corporation normal-tax net income, is to tax the "income of every corporation." The critical question in the present case is whether the income of a separate legal entity, here a partnership, can lawfully be treated as the "income of" petitioner corporation. The Tax Court's opinion (R. 277-284) does not cite any of the above sections.

The provisions governing the allowance of the excess profits credit for the years in question (Item 2 under

Questions Presented) are derived from the Revenue Act of October 8, 1940, *supra,* imposing the excess profits tax, 26 U.S.C., 1940 ed., Secs. 711(a)(2), 712(a), 714-720; *Ibid.,* Supp. II; *Ibid.,* Supp. IV. On this issue, Rule 50, Rules of Practice before the Tax Court of the United States, is also involved, and is quoted in the Argument, *infra,* pp. 58-59.

The Material Facts.

The material facts, all of which are based on uncontradicted evidence, may be summarized as follows:

Petitioner's business prior to 1941. Petitioner, an Oregon corporation with its principal office at Eugene, Oregon, was engaged in the sale of lumber and building supplies, until 1941 at Eugene and Junction City, Oregon, and until 1937 at Cottage Grove, Oregon (R. 268; R. 5, 20, 46, 145-146).[1] In 1941 petitioner had outstanding 946 shares of stock at a par value of $94,600, or $100 a share. Half, or 473, of these shares were owned by John J. Rogers, petitioner's president, and 35.3 shares were owned by Louis C. Scharpf, petitioner's secretary-treasurer. The remaining 437.7 shares were owned by Scharpf's wife, Eva M. Scharpf, having been purchased by her, for the most part prior to 1930, with inherited funds (R. 268; R. 36, 40, 75-76, 80, 156-157, Pet. Exh. 18).

During the years 1935-40 petitioner's books showed assets which were carried at totals ranging from $117,-283.26 in 1938 to $150,531.66 in 1940. These assets con-

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[1]Where the references are separated by a semicolon, the reference preceding the semicolon is to the Tax Court's finding of fact and the subsequent references are to the supporting evidence.

By order of this Court (R. 347) the exhibits are not printed but may be referred to by counsel and considered by the Court.

sisted chiefly of merchandise inventory and accounts receivable; in addition there were land, buildings, furniture and fixtures, which had a book value of about $37,000 (R. 268-269; R. 29-30, 46, Pet. Exh. 1). The land and buildings consisted of town lots at Eugene, improved with a concrete building and hydraulic elevator, a large frame building, a storage shed and a spur railway track; two lots at Junction City, improved with a hollow tile warehouse and a wooden shed; and at Cottage Grove, an old warehouse and vacant lots. Prior to 1941, petitioner also occupied leased premises. The Cottage Grove property was sometimes rented, but produced little income (R. 270, 271; R. 44-45, 145-146).

During 1935-40 petitioner usually sustained small operating losses, but receipts from other sources produced net income of a little over $2,000 for 1936, 1937 and 1939, $677.05 for 1935, and $6,036.35 for 1940 (R. 269; R. 30, Pet. Exh. 3). For 1938 petitioner had a loss of $511.65 (Pet. Exh. 3).

At the close of 1940 petitioner's balance sheet showed the following assets and liabilities (R. 270; R. 29-30, Pet. Exh. 1):

ASSETS

Cash		$ 243.96
Notes and Accounts Receivable		37,477.76
Merchandise		70,892.48
Investments		2,926.09
Land		23,993.25
Buildings	$26,276.49	
Furniture	6,959.28	
Trucks	5,239.49	
	$38,475.26	
Less: Depreciation	23,653.78	
	$14,821.48	14,821.48
Prepaid Insurance		176.64
Total		$150,531.66

LIABILITIES

Accounts Payable	$ 16,271.55
Notes Payable	34,238.00
Accrued Taxes	3,001.89
Earned Surplus	2,420.22
Capital Stock	94,600.00
Total	$150,531.66

The accounts or notes payable included $2,144 due Rogers, of which $1,200 was for salary and $944 for dividends; $1,270.60 due Scharpf, of which $1,200 was salary and $70.60 dividends; $873.40 due Eva M. Scharpf, for a dividend; and $1,500 due Rogers' wife, Corabelle M. Rogers, on a note (R. 270; R. 68-70). The debt last mentioned was in consideration of $1,500 actually advanced by Corabelle M. Rogers to the corporation and the other liabilities listed were likewise *bona fide* obligations of petitioner (R. 131-132, 156).

Rogers and Scharpf had become stockholders of petitioner in the late twenties, when they became acquainted and decided to conduct the lumber and supply business in corporate form (R. 39, 80, 92-93, 139). Both were actively engaged in the business throughout the intervening years to 1941. Rogers purchased stocks of lumber, shingles, moulding and coal and had charge of credit and collections. Scharpf made purchases of all the other building materials handled and he was in charge of all sales. They received equal salaries from petitioner which, combined, ranged from $9,800 in 1937 to $14,400 in 1940 (R. 269; R. 30, 80-81, 116, Pet. Exh. 3).

Petitioner's withdrawal from the lumber and building supply business in January 1941. In the latter part of 1939 Scharpf suggested to Rogers that the business be

conducted as a partnership (R. 269; 40-41, 97, 116, 140).[2]

Scharpf believed that the 35.3 shares which he owned in petitioner, out of the 946 shares outstanding, did not adequately reflect his value to the enterprise (R. 41, 75, 93-95, 116, 137). He was also of the opinion that the business could be more readily liquidated, when he might so elect, if conducted in partnership rather than in corporate form (R. 61, 137). Neither Rogers nor Scharpf at any time gave weight to the advantages and disadvantages from a tax standpoint of doing business in the corporate as distinct from the partnership form (R. 85, 86, 97, 115, 140-141, 142, 150-151).[3]

Rogers was not agreeable to the change proposed by Scharpf, being reluctant to assume the unlimited liability of a partner (R. 41, 97, 140). Scharpf persisted, however, and during 1940 both had a number of conferences with

[2]Approximately $36,000 of the total deficiency of about $56,000 which the Commissioner seeks to impose upon petitioner for the years in question (*supra,* page 1) consists of claimed excess profits tax liability which Rogers and Scharpf allegedly sought to avoid by doing business in partnership rather than in corporate form. It is to be noted from the above finding and supporting evidence that Scharpf first suggested the formation of a partnership in "the latter part of 1939." It is also to be noted that the wartime excess profits tax was first adopted in the Revenue Act of October 8, 1940 (*supra,* pp. 7, 8). This is mentioned in the Argument (*infra,* p. 32).

[3]The statements made in this paragraph, all based on uncontradicted testimony, are not included under the Tax Court's "Findings of Fact," nothing being said therein as to the purpose of the parties in transferring the business from petitioner to the partnership. We agree with the implication to be drawn from this omission, in that we believe and contend that the motive of Rogers and Scharpf and the others concerned is wholly immaterial to this case. (See Argument, *infra,* pp. 31-33.) The statements contained in the above paragraph are included, as pertinent to our later argument, solely because of certain comments made in the Tax Court's "Opinion" (*infra,* p. 20).

E. R. Bryson, an attorney who had given them advice for many years (R. 269; R. 93, 101-102). Scharpf saw no point in continuing petitioner and favored a complete liquidation of it prior to January 1, 1941 (R. 141). Rogers finally consented to the partnership on condition that petitioner remain in existence and continue to hold the real estate (R. 41, 97, 98, 141). Pursuant to a compromise arrangement, Rogers, Scharpf and their wives (Mrs. Rogers being included at Rogers' suggestion) decided to enter into a partnership agreement as of January 1, 1941, whereby the four were to conduct the business as equal partners with operating assets which petitioner was to transfer to them and on premises which petitioner was to retain and rent to them. Rogers and Scharpf were to continue to perform the character of work previously performed by them, and each was to be entitled to a "salary" (of $6,600 a year) in addition to his respective share of the profits (R. 269, 271; R. 35, 41-42, 141, 155, 157, Pet. Exh. 15).[4]

At stockholders' and directors' meetings of petitioner held on January 2, 1941, it was voted to accept the offer of the partnership and to transfer the lumber and builders supply business to it (R. 32, Pet. Exhs. 8, 9). Pursuant to the offer and acceptance, petitioner thereupon, as of January 1, 1941, transferred to the partnership its current assets at book value in consideration of the assumption by the partnership of certain of petitioner's accounts

[4]The Tax Court's findings of fact include a long paragraph reciting various provisions of the partnership agreement (R. 272-273) and contain one or two other items concerning the internal organization of the partnership. These statements are not included herein because they appear to be immaterial to any issue before the Court. (See Argument, *infra*, pp. 33-36.)

and notes payable and the partnership's note with 2% interest for the balance. The assets so transferred consisted of petitioner's cash ($243.96), notes and accounts receivable ($37,477.76), inventory of merchandise ($70,-892.48), investments ($2,726.09) and delivery equipment ($1,809.61), of an aggregate value of $113,149.90. In return, petitioner was enabled to eliminate from its accounts and notes payable $16,271.55 and $7,500, respectively, in a total amount of $23,771.55. The difference between these amounts ($113,149.90 less $23,771.55) was represented by the partnership's note for $89,378.35, with 2% interest, payable in one year, dated January 2, 1941. The foregoing transactions were correctly reflected in petitioner's books as of January 1, 1941 (R. 273-274; R. 29-30, 33, 42-43, 43-44, 47, Pet. Exhs. 1, 11).

As of the same date partnership books were opened, correctly reflecting its side of the transaction (R. 37, 81, Pet. Exh. 22). These books showed as assets of the partnership the cash, notes and accounts receivable, merchandise, investments and delivery equipment in the same amounts as previously carried on petitioner's books and also an account receivable of $500 from Mrs. Rogers (satisfied in cash). Partnership liabilities were shown as accounts payable of $16,271.55, notes payable of $89,-378.35, and partners' investment accounts of $8,000 (R. 274; R. 31, 66-67, 72, 154-155, Pet. Exhs. 4, 22). The amount of the partners' contribution, of $8,000 or $2,000 each, was decided upon in the light of the fact that this amount had represented the average borrowings of petitioner when it conducted the business (R. 42, 152). The amount was provided largely by the cancellation of amounts owed to the partners or related

interests by petitioner, the consequent adjustment to the benefit of the partnership being reflected in the above figures (R. 32, 67-72, 118-120, 131-133, 152-155, Pet. Exh. 7). Subsequent experience proved the partners correct in their judgment of the amount of capital required (R. 31, Pet. Exhs. 4, 6).

Also, in accordance with the offer and acceptance, petitioner changed its then existing name of Twin Oaks Builders Supply Company to its present name of Twin Oaks Company, filing amended Articles of Incorporation reflecting the change in name with the Oregon Corporation Commissioner in January 1941 (R. 83). Thereupon the partnership assumed the name Twin Oaks Builders Supply Company (R. 63). And, in accordance with the offer and acceptance, petitioner leased to the partnership its remaining fixed assets, consisting of real property, fixtures and equipment, for $3,000 a year. The lease contained a provision requiring an adjustment of rent in the event of substantial additions to or diminution of the leased property (R. 36, 44-45, Pet. Exh. 17).[5]

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[5]According to the uncontradicted testimony, assets of the character here involved are customarily sold in the building trade on the basis of book value or market value, whichever is lower, and this is a reasonable method of valuation (R. 43, 56). Likewise, according to the uncontradicted testimony, a loan of the character made by petitioner to the partnership would not customarily draw as high an interest rate as that charged by banks, there being no standard rate for such a loan (R. 186-187). There was also testimony that a yearly rental of $3,000 constituted the fair rental value of the properties included within the lease (R. 45, 54-61, 61-63, 144, 162-172, 172-176, 201, 249-252), although on this point alone the Commissioner presented witnesses who sought to fix a different, higher value (R. 202-234, 235-248). The Commissioner's witnesses were not familiar with business conditions in the building industry in January 1941 or otherwise, and had only a passing familiarity with the properties involved.

The Tax Court made no reference to these matters, either in

A partnership agreement was signed on January 25, 1941, as of January 1, 1941 (R. 271; R. 35, Pet. Exh. 15).

The operation of the business beginning January 1941. By notice dated January 16, 1941, the partnership notified the State Industrial Accident Commission, Oregon, that it was engaged in the business formerly operated by petitioner and that the business constituted a hazardous occupation within the meaning of the State Workmen's Compensation Act (R. 47-48, Pet. Exh. 23). On or prior to January 25, 1941, the partnership filed with the State Unemployment Compensation Commission a registration as owner of the business, previously registered in the name of petitioner, pursuant to the provisions of the State Unemployment Compensation Act (R. 48-49, Pet. Exh. 24). The partnership filed its own contribution reports with this Commission beginning with the year 1941 (R. 50-51). The partnership applied for and received from the Collector of Internal Revenue at Portland, Oregon, an identification number, pursuant to the Federal Social Security Act (R. 49-50, Pet. Exh. 25). The partnership advised the First National Bank of Eugene, on January 2, 1941, of the transfer of the business and opened its own account with the Bank (R. 274-275; R. 45, 181-182, 189, Pet. Exh. 36).

The stationery used by the partnership carried a different letterhead from that used by the petitioner prior or subsequent to January 1, 1941, the names of Rogers and

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its findings of fact or opinion or elsewhere; it did not, and we believe could not, question the *bona fides* of the details of these transactions or the reasonableness of the consideration supplied by the partnership. We, therefore, do not detail the evidence on these points.

Scharpf as officers being eliminated (R. 134-135, Pet. Exhs. 30, 31). The partnership, on January 18, 1941, filed an assumed business name certificate with the County Clerk, Lane County, Oregon, showing that it was doing business as Twin Oaks Builders Supply Company, and, as required by Oregon law, published notice to this effect (R. 36-37, 135-136, Pet. Exh. 19).

The partnership had some 30 employees (R. 129). Rogers and Scharpf headed the business, each performing the same general character of work he had performed, prior to 1941, for petitioner (R. 81, 133).[6] All purchases of building supplies used in the course of the business and all sales were made by and in the name of the partnership and exclusively upon its credit. All income realized by the partnership was accounted for on its books and records and all debts and liabilities incurred in the business were accounted for and paid by the partnership (R. 45, 46, 193-195). Its dealings with petitioner were limited to the payment of rent, the renewal and final payment with interest, in December 1946, of its note for $89,378.35, and one or two other incidental transactions unrelated to the lumber and building supply business (R. 33, 195-196, Pet. Exh. 10).[7]

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[6]The Tax Court's findings of fact include the statement that "After January 1941 the lumber and builders supply business was conducted by Rogers and Scharpf as before; * * *" (R. 275). This is correct, as stated in the text, above, in that, as partners, they continued to head the business and perform the same general character of work. The court's statement would be patently incorrect and inconsistent with other findings if construed to mean that Rogers and Scharpf continued such duties as officers of petitioner or in any way through or for petitioner.

[7]The Tax Court's findings of fact include the statement without explanation that "The partnership has endorsed peti-

The net income of the partnership during its first four years, prior to allowance for the salaries of Rogers and Scharpf, was (R. 276; R. 31, 136, Pet. Exh. 5); 1941—$29,776.20; 1942—$18,525.29; 1943—$42,086.52; and 1944—$66,119.33.

Petitioner's activities beginning January 1941. Beginning January 1941, petitioner's activities were limited to owning and leasing real estate and equipment (R. 73-74). Its income for the years 1941-1944 consisted of the $3,000 rent, interest on the partnership note and some very petty miscellaneous items. Its net income for these years was as follows: 1941—net loss of $904.83; 1942—$626.28; 1943—$803.13; and 1944—$419.57 (R. 30, Pet. Exh. 2). All income realized by petitioner was accounted for on the separate books and records of petitioner, and all debts and liabilities incurred by petitioner were accounted for and paid by it (R. 45, 181, 193-195).

In 1941, Rogers and Scharpf, as petitioner's officers, drew salaries of $600 each. Thereafter, they drew no salaries. Petitioner had no other employees (R. 30, 51-52, 117, Pet. Exh. 2). In July 1941, petitioner bought a lot and an old frame residence adjoining its property in Eugene for between $3,500 and $4,000 and caused the building to be demolished. In December 1943, petitioner bought another lot and residence in Eugene for $2,500. Both of these properties were added to the aggregate properties

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tioner's notes for bank loans" (R. 276). This reference is limited to renewals of loans owed by petitioner to the Bank at the time of the transfer of the business in January 1941. The Bank insisted that the partnership endorse such renewal notes and, consistently with the January 1941 transaction, the partnership did so (R. 182-183, 186, 187, Pet. Exh. 37).

leased to the partnership, the former being used in the partnership business and the latter being rented (R. 122-124, 124-126, 143). As of the beginning of 1946, the partnership's rent under the lease from petitioner was increased to $4,200 a year (R. 276; R. 35, Pet. Exh. 14).

Tax returns and claimed deficiencies. Petitioner filed corporation income and declared value excess profits tax returns for the years in question and paid the taxes shown to be due. The partnership filed tax returns reporting its income for these years and the members of the partnership, as required by law, reported their individual shares of the income and paid taxes upon it. The Commissioner thereafter determined deficiencies in *petitioner's* income and declared value excess profits taxes for the years 1942, 1943 and 1944 and excess profits taxes for 1943 and 1944 by including in petitioner's income the net income reported by the partnership, with certain adjustments. In justification, the Commissioner's theory was that the partnership, the transfer of assets and the lease were without substance and should be disregarded for federal tax purposes. On the same reasoning the Commissioner disallowed for 1942 petitioner's carryover of its operating loss of 1941. The Commissioner also determined penalties against petitioner for its failure to file excess profits tax returns for 1943 and 1944 (R. 276-277; R. 10-19, 196-199, Pet. Exhs. 38, 39, 40).

In addition, the Commissioner included in the personal net income of Rogers for 1943 and 1944 the share of the net income of the partnership distributable to and reported by Mrs. Rogers for these years, and asserted deficiencies in income taxes against Rogers on this basis

(R. 199, Pet. Exh. 42). Also, the Commissioner included in the net income of Scharpf for these years the share of the net income of the partnership distributable to and reported by Mrs. Scharpf and asserted deficiencies in income taxes against Scharpf on this same basis (R. 200, Pet. Exh. 43). Both Rogers and Scharpf made payments on account of the deficiencies asserted (R. 199, 200, Pet. Exhs. 41, 44).[8]

The Tax Court found the facts substantially as summarized above, with a few exceptions by way of facts added to or omitted from its findings as noted in the footnotes, pp. 11, 12, 16-17, 19.

Opinion and Decision of the Tax Court.

After again summarizing in its opinion certain of the facts set out above concerning the transfer of the business out of petitioner's hands (R. 278-280), the Tax Court, nevertheless, concluded that it did not "perceive substance in these forms" (R. 280) and characterized the transfer as "a scheme which had no substantive effect whatever on the business" (R. 281-282). Early in its opinion (R. 278) the Tax Court declared that "An arrangement whereby income is spread, as here, among members of family groups invites special scrutiny," citing *Helvering v. Clifford,* 309 U.S. 331, a family trust case. The

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[8]These facts as to the deficiencies asserted against Rogers and Scharpf are not mentioned by the Tax Court. Reference is made to them in the Argument, *infra,* p. 35. The deficiencies asserted against Rogers and Scharpf were upon the theory that the partnership was to be recognized but that for tax purposes the income must be reallocated among the partners—a theory wholly inconsistent, of course, with that of the deficiencies asserted against petitioner (alone involved in the present case), which deny recognition to the partnership.

court did not question that, beginning in January 1941, the lumber and building supply business had in fact been conducted by the partnership or that the income in question was derived exclusively from such business. However, the court outlined certain of the testimony concerning the formation of the partnership, and the inclusion of Rogers' wife as a partner, and, without purporting to make a factual finding on the point, commented that this "testimony, in our opinion, affirmatively supports the respondent's view that the purpose of the partnership was to achieve a reallocation of income among family groups. The result was certainly accomplished, for the interests of the three shareholders were equally divided among the four spouses." (R. 283).

On this basis the Tax Court sustained the Commissioner in attributing to *petitioner* the income of the partnership. On the same basis it disallowed petitioner's operating loss carryover from 1941 to 1942. The court held against the Commissioner only as to the penalties proposed by him (R. 284).

Thereafter, the case came before the court for computation of the deficiencies, under the Tax Court's Rule 50. At this point the court refused to deal on the merits with petitioner's claim that, under the court's own holding, disregarding for tax purposes the partnership as a separate legal entity, petitioner's excess profits credit should be computed by including the invested capital and accumulated earnings and profits of the partnership. The court held that "as no issue was raised in the pleadings as to the computation of taxes under respondent's determination that the partnership should not be recognized,

none may be now raised and decided under Rule 50." (R. 326). Accordingly, decision was entered (R. 326) in the maximum amount stated in the deficiency notice, excepting only the penalties (*supra*, p. 1).

The findings of fact, opinion and decision of the Tax Court, as referred to above, were those of the single member of the court who heard the evidence. Following the entry of the findings and opinion on March 23, 1949 (R. 267-284), petitioner, on April 19, 1949, filed a timely motion for reconsideration and review of the case by the entire court, pursuant to the Tax Court's Rule 19 (R. 3, 284-285). However, orders were entered on April 25 and 26, 1949, denying the motion for reconsideration, and for review by the full court (R. 4).

SPECIFICATION OF ERRORS

The Statement of Points to be Relied on by Petitioner on Review (R. 339-344), to which reference is made, details the errors urged against the Tax Court.

The first 13 specifications are concerned with the fundamental error of the court (i) in deciding that there were deficiencies in petitioner's income taxes, declared value excess profits taxes and excess profits taxes in the amounts stated in its decision or in any amount (Item 1). More particularly, the court erred (ii) in attributing and taxing to petitioner the income of a separate legal entity, a partnership (Item 2), by deciding (iii) that the transfer of petitioner's business and the assets thereof, the lease of its real property, and the partnership itself were without substance and could not be recognized for federal tax purposes (Items 3, 4, 5, 8, 9), (iv) that after January 1, 1941,

the lumber and building supply business was conducted in the same manner and with the same assets as prior thereto (Items 6, 8), (v) that the partnership contributed nothing in services or capital to the production of the income from the business (Items 7, 10), (vi) that the business as conducted by petitioner prior to January 1941 was unitary in character and not susceptible of any logical division (Item 11), (vii) that the result of the transfer of the business to the partnership, and perhaps the purpose of the transfer, was to achieve a reallocation of income among family groups (Items 3, 12); and (viii) in purporting to determine for tax purposes the status of the partnership and the relationship of the individual partners among themselves, in a proceeding to which neither the partnership nor the individual partners are parties and which does not present these issues (Item 13).

The foregoing specifications of error are involved in the first question presented (*supra,* p. 6) and are dealt with in Point I of the Argument (*infra,* pp. 24-50).

The remaining two specifications are concerned with the errors of the Tax Court, with respect to the computation of the deficiencies for purposes of entering its decision, in (ix) entering as its decision the computation of deficiencies submitted by the Commissioner, and in refusing to enter as its decision the computation submitted by petitioner (Item 14), and (x) holding that the right to object to the method of computing such deficiencies employed by the Commissioner had been waived by petitioner (Item 15).

The specifications of error outlined in the next preceding paragraph are involved in the second question presented (*supra,* pp. 6-7), and are dealt with in Point II of

the Argument (*infra,* pp. 51-61). These specifications need not be considered unless the Court holds with the Commissioner on the first 13 specifications.

SUMMARY OF ARGUMENT

Point I of the Argument deals with the fundamental question of whether there can be attributed and taxed to petitioner the earnings of the partnership. Our position on this question has been summarized under the Substance of the Controversy, *supra,* pp. 2-6, and is put briefly at the beginning of Point I, *infra,* pp. 24-25. The Argument is developed under the following headings:

Petitioner Did Not Conduct the Business Which Produced the Income in Question. There Is No Legal Basis Upon Which Such Income Can Be Taxed to Petitioner.

A. The Controlling Law.
The *Gregory v. Helvering* qualification.
The significance of motive.
The internal organization of the partnership.

B. Cases Dealing with Similar Fact Situations.

C. Application of the Law to the Facts.

It will be unnecessary for the Court to consider Point II of the Argument unless it agrees with the Commissioner on Point I. Only in that event is the Court required to decide whether, as we contend, the Tax Court compounded its first error by attributing the partnership income to petitioner but at the same time denying it the credits againt such income to which it would be entitled if the earnings of the partnership did belong to it. This point is treated under the following headings:

The Tax Court Erred in Failing to Include, When Computing Petitioner's Excess Profits Credit for 1943 and 1944, the Invested Capital and Accumulated Earnings and Profits of the Partnership as of the Beginning of Each of These Taxable Years.

A. The Error in Computing the Credits.

B. Petitioner Did Not Waive a Correct Computation of Its Taxes.

Finally, Point III of the Argument contains a very brief discussion of the scope of review in Tax Court cases. The present is not a "fact" case, the Court's review being essentially a re-examination of the applicable law. This topic is included primarily for the sake of the completeness of the discussion.

ARGUMENT

I.

Petitioner Did Not Conduct the Business Which Produced the Income in Question. There Is No Legal Basis Upon Which Such Income Can Be Taxed to Petitioner.

Two fundamental principles of taxation control the present case: The revenue laws do not, and constitutionally could not, tax A (here, petitioner) on income earned by B. Persons are entitled to conduct a business in any way they choose, being held to the tax consequences of the manner in which they actually handle their affairs (Subsections A and B, *infra*).

Applying these principles to the uncontradicted facts, set forth *supra*, pp. 8-19, it is clear that petitioner, in January 1941, withdrew from the lumber and building

supply business here involved. Thereafter this business was conducted not by petitioner but by a separate legal entity. This entity happens to have been a partnership, but whether it was a partnership, a sole proprietorship, another corporation, or some business entity known only to the local law, is immaterial. The point is that it was not petitioner which conducted the business. Factually, or economically, it was the work of the partners, as partners, and their employees, and the credit and property of the partnership, which generated the income here in dispute. The corporation did not conduct the business and did not produce the income. Therefore, the income cannot be attributed to the corporation (Subsection C, below).

This is the sum and substance of the case.

A. THE CONTROLLING LAW.

The Gregory v. Helvering qualification. The Commissioner is not likely to dispute, in terms, the principles just referred to, that A cannot be taxed on the income of B and that persons are free to choose the method of doing business which they desire. He must rely, rather, on the qualification, inherent in these principles, that the tax laws look to substance rather than to form, and that if income which appears to be that of A is factually and economically attributable to B, then B may fairly be taxed upon it. Typical cases which may be cited for this qualification are *Gregory v. Helvering,* 293 U.S. 465; *Helvering v. Bashford,* 302 U.S. 454; *Higgins v. Smith,* 308 U.S. 473; *Commissioner v. Court Holding Co.,* 324 U.S. 331; *Lucas v. Earl,* 281 U.S. 111; *Helvering v. Horst,* 311 U.S. 112; and *Harrison v. Schaffner,* 312 U.S. 579. This line of cases stands for the rule that "In tax matters the realities of a

transaction, not artificialities, are given effect'' (*Nordling v. Commissioner,* 166 F.2d 703 (9th Cir.), certiorari denied, 335 U.S. 817). We have no occasion to dispute this rule. Instead, we emphasize it in the interest of a correct analysis of the present case.

The first four cases above cited dealt with isolated, transitory transactions which were conducted in such a manner as to create an appearance which did not correspond with reality; the apparatus employed, such as the dummy corporation used as a conduit in the *Gregory* case, served no economic function and generated no income.[9]

The next three cases, beginning with *Lucas v. Earl, supra,* involved anticipatory arrangements whereby, in the familiar language of that case (281 U.S. at p. 115), ''the fruits are attributed to a different tree from that on which they grew.''[10]

None of these cases dealt with factual situations which even remotely resemble the instant case. As applied here, these cases limit the field of inquiry to the question: Can it fairly be said that the corporation produced the income of the business?

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[9]*Gregory v. Helvering* (transfer of securities to taxpayer-stockholder via corporation which was organized to serve as conduit and was thereafter immediately dissolved); *Helvering v. Bashford* (X corporation held not a party to a reorganization because its ownership of securities was (p. 458) ''transitory, and without real substance''); *Higgins v. Smith* (taxpayer-stockholder did not effect surrender of securities by transferring them to controlled corporation); *Commissioner v. Court Holding Co.* (corporation used its stockholders as mere conduit in sale of its assets).

[10]*Lucas v. Earl* (husband by contract sought to attribute one-half of earnings to wife); *Helvering v. Horst* (father sought to attribute interest-income to son by transfer of bond coupons); *Harrison v. Schaffner* (assignment by life beneficiary of *income* of trust).

Where the rule of the foregoing cases is applicable, it has usually been a corporate entity which has been deemed fictitious and ignored rather than some other type of business entity, like, as in this case, a partnership. We assume, as did the Tax Court in *Seminole Flavor Co.*, 4 T.C. 1215, 1234, that, when appropriate, business entities other than corporations are similarly to be disregarded and that the test is essentially the same. The holdings and reasoning of the above-cited cases make it manifest, however, that this line of authorities provides simply a qualification of the general principles of taxation. "In tax matters it is only under exceptional circumstances that the separateness of the corporation from the stockholders can be disregarded, even when there is but one stockholder." *Ross v. Commissioner,* 129 F.2d 310, 313 (5th Cir.).[11]

In several situations this Court has had occasion to draw a line excluding application of the *Gregory v. Helvering* doctrine. *Samson Tire & Rubber Corporation v. Rogan,* 136 F.2d 345 (9th Cir.), certiorari denied, 320 U.S. 770 (*bona fides* of taxpayer's sale of tires and tubes sustained, contrary to Government's contention); *Guaranty Trust Co. v. United States,* 139 F.2d 69 (9th Cir.) (second transaction—bank held to be the substantial party to the transaction rather than the holding company, as contended by the Government). Similarly, this Court has held that A, an assignor, could not be taxed on the income of B, an assignee (even though, unlike the present case, B did not conduct a business or otherwise contribute to the production of the income), where the assignment did not con-

[11]The *Seminole Flavor* and *Ross* cases, both holding for the taxpayer, are discussed, *infra*, pp. 37, 38.

stitute a mere attempt to shift income but involved the income-producing corpus itself. *United States v. Spalding,* 97 F.2d 701 (9th Cir.), certiorari denied, 305 U.S. 644 (assignment of interest in oil permit). Here, this Court applied the decision in *Blair v. Commissioner,* 300 U.S. 5 (income taxed to transferee, not transferor, as contended by Commissioner, where transfer involved equitable interest in the trust).

The significance of motive. Several of the *Gregory v. Helvering* line of cases have considered the significance to be attributed evidence as to the taxpayer's motive in the transaction under review: If the thing which was done had substance in that factual or business consequences, apart from or in addition to tax results, attached to it, *then a tax-saving motive is immaterial.* When, but only when, the thing done appears to be without substance, or otherwise *equivocal,* can the questions of motive and purpose be explored for the light which they may throw upon the true nature of the transaction. *Gregory v. Helvering,* 293 U.S. at p. 469;[12] *Brunton v. Commissioner,* 42 F.2d 81, 82 (9th Cir.), certiorari denied, *sub nom., Brunton v. Burnet,* 282 U.S. 889.[13]

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[12]The Court there said:

"* * * if a reorganization in reality was effected within the meaning" of the statute, the tax motive "will be disregarded. The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted. * * * But the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended."

[13]In the *Brunton* case, this Court declared:

"It is to be conceded that the contract is not to be deemed ineffectual merely because the purpose of the decedent may have been to avoid the heavier tax rate of 1921.

This Court again employed the same approach in holding for the taxpayer in *Samson Tire & Rubber Corporation v. Rogan,* 136 F.2d at p. 347:

> "One purpose of the agreement between appellant and Products was to avoid the imposition of excise taxes on tires and tubes manufactured by appellant before June 21, 1932. That was a legitimate purpose. * * *
>
> "The court [below] did not find that the agreement between appellant and Products was unreal or a sham, nor did the evidence warrant such a finding. The court found that the agreement served no business purpose, but that finding is clearly erroneous. The evidence shows that the agreement had a business purpose, namely, to sell the merchandise, including tires and tubes, described in the agreement at the price and on the terms specified therein, and that that purpose was accomplished."[14]

Similarly, the Tax Court, in dealing with cases involving the identical question presented here of whether a corporation could be taxed on the income of a separate

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> * * * But in interpreting an *equivocal* transaction motives may be considered *as bearing on the real nature thereof.*" (Italics ours.)

In this connection, the Court cited *Texas & N. O. R. Co. v. Ry. Clerks,* 281 U.S. 548, a nontax case, in which the Supreme Court observed (at p. 559):

> "Motive is a persuasive interpreter of *equivocal* conduct, and the petitioners are not entitled to complain because *their activities were viewed in the light of manifest interest and purpose.*" (Italics ours.)

[14]To the same effect as to business purpose and motive are, among many other cases which might be cited: *Commissioner v. Kolb,* 100 F.2d 920, 926 (9th Cir.); *Commissioner v. Gilmore's Estate,* 130 F.2d 791, 795-796 (3d Cir.); *Commissioner v. H. P. Hood & Sons,* 141 F.2d 467, 471 (1st Cir.), quoting Mr. Justice Holmes in *Bullen v. Wisconsin,* 240 U.S. 625, 631.

business entity, has employed this same reasoning. *Seminole Flavor Co.,* 4 T.C. 1215, 1231, 1235; *Buffalo Meter Co.,* 10 T.C. 83, 88-89; *Miles-Conley Co.,* 10 T.C. 754, 762, affirmed as to another issue, on taxpayer's appeal, 173 F.2d 958 (4th Cir.). These cases, all holding for the taxpayer, are discussed *infra,* pp. 38-40. At this point, however, it is pertinent to note the following reasoning of the Tax Court's opinion in the *Buffalo Meter Co.* case (10 T. C. at pp. 88-89):

> "The partnership here was in no sense 'unreal or a sham'. *Higgins v. Smith, supra.* As to the assets which it acquired from the petitioner [the corporation], there was a complete shift of economic interests from the corporation to the partners. It was none the less so because the partners were, and continued to be, corporate stockholders. * * *
>
> "The partners had what in their opinion were sound business reasons for organizing the partnership. *The important consideration is that the partnership was real for all purposes and that it has at all times functioned as an entirely separate economic entity.*" (Italics ours.)

It is to be seen that the Tax Court in the above cases faithfully applied the analysis provided by the Supreme Court and this and other Courts. Manifestly, the single judge of the Tax Court in the instant case failed to employ the same approach.

A striking confirmation of the foregoing cited cases as to the significance of motive, and the scope of the *Gregory v. Helvering* doctrine, is provided by the very recent case of *United States v. Cumberland Public Service Company,* decided by the Supreme Court on January 9, 1950 (opinion

by Mr. Justice Black for a unanimous Court). Distinguishing *Commissioner v. Court Holding Co., supra,* on its facts, the Court held that the sale of assets involved in the *Cumberland* case was made by the stockholders themselves and not by or for the corporation, which had distributed the assets to its stockholders immediately prior to the sale. The Court, therefore, sustained the decision of the Court of Claims, holding that the corporation was not taxable on the sale. The Supreme Court noted the Court of Claims' finding that the method by which the stockholders disposed of the property "was avowedly chosen in order to reduce taxes," but concluded its discussion of this subject with the statement: "Whatever the motive and however relevant it may be in determining whether the transaction was real or a sham, sales of physical properties by shareholders following a genuine liquidation distribution cannot be attributed to the corporation for tax purposes."[15]

The Tax Court's opinion in the present case contains practically no discussion or analysis of the doctrine of *Gregory v. Helvering.* In its findings of fact, as noted *supra,* p. 11, it included no finding as to the motives behind the transfer of the business out of petitioner's

[15]As mentioned, the instant decision affirmed the decision of the Court of Claims. The Supreme Court, however, reviewed the decision below to determine whether the factual findings were adequately supported by the evidence and whether the correct rules of law had been applied. The statement as to motive, quoted above, is obviously a legal rule, of general application, which neither the Court of Claims nor any other court is free to disregard.

The case presently before this Court requires no extended discussion of the scope of appellate review in Tax Court cases. A brief comment upon the subject is found under Point III, *infra,* pp. 61-62.

hands. The Tax Court's opinion, however, does mention certain of the testimony relating to the matter, although the court appears less concerned with the transfer of the business from petitioner to the partnership than with the internal organization of the partnership itself. In this connection, the court mentions Scharpf's testimony that he wanted "a decent share of the profit" and the testimony as to the inclusion of Rogers' wife in the partnership. The court then comments that this testimony affirmatively supports the Commissioner's "view," and that the "result" was to divide the interest of petitioner's three shareholders among the four spouses (R. 283).

The Tax Court's preoccupation with the internal organization of the partnership is briefly considered, *infra,* p. 33. At this point is is sufficient to emphasize: (1) The uncontradicted evidence shows that tax considerations played no part whatsoever in the transfer of the business from petitioner to the partnership. Petitioner's income from the business, indeed, had been so slight in the years prior to 1941 as to make this understandable even in the absence of explicit testimony (*supra,* p. 9). And the partnership was urged by Scharpf well before the excess profits tax, to which the bulk of the total deficiency is due, had been adopted (fn. 2, *supra,* p. 11).

(2) On the present record a tax-saving motive, even had it existed, would be irrelevant under the decisions previously considered, including the recent decision of the Supreme Court in the *Cumberland* case. For here there was a genuine transfer of the business to the partnership, which thereafter produced the income in dispute. The partnership actually functioned, and has been functioning since January 1941; the business was conducted by the

partnership, with all the incidents thereof, including personal liability of the partners; there was a complete satisfaction of the business purpose requirement under *Cumberland, Samson, Kolb, Gilmore's Estate, Hood* and other cases. On the facts there was nothing *equivocal* which the motives of the parties could illumine.

The internal organization of the partnership. It appears that the Tax Court's emphasis upon the internal organization of the partnership, such as the distribution among the four partners of the earnings of the business, influenced its decision in the case. Apart from what has already been noted, *supra,* p. 20, the Tax Court pointed out that Mrs. Rogers and Mrs. Scharpf, in addition to their one-fourth interests in the profits of the partnership after salaries, each received $25 a month as a "salary" (R. 273). Three times in its opinion the court mentioned the compensation of the partners (R. 280, 281, 283), characterizing the wives' services as "negligible" (R. 281). The court's conception seems to have been that the internal organization of the partnership was such as to distort the amounts of income received by the respective partners, and that *this* justified it in taxing the partnership's earnings to *petitioner.*

It could be replied that, according to the uncontradicted evidence, the wives in fact did render services to the partnership, in signing the semi-monthly payroll checks and listing accounts receivable (R. 128-129, 160); and that if their services were "negligible," so were their salaries of $300 each a year. It could also be argued that the partnership's distribution of net income, after salaries, corresponded more nearly to economic fact than did such distribution when the business was conducted by peti-

tioner, prior to 1941. As we have seen, Rogers and Scharpf were at all times the active heads of the business. Yet, as owner of 437.7 shares in petitioner (*supra*, p. 8), Mrs. Scharpf was thereby entitled to about 45% of the net earnings of the business when conducted by petitioner. As a result of the arrangement among the partners, Mrs. Scharpf's interest was reduced to only 25% of the net earnings of the business, after 1940, when it was conducted by the partnership. Scharpf's share, as an active head of the business, was proportionately increased from less than 5%, as the owner of only 35.3 shares in petitioner, to 25%. This, if a very faint touch of humor may be injected, should have delighted the Commissioner rather than brought down his wrath.

Mrs. Rogers was not a stockholder in petitioner but did obtain a one-fourth interest in the partnership upon payment of her aliquot contribution. It is to be remembered, nevertheless, that, in view of the meager earnings of the business prior to 1941, a one-fourth interest in the partnership could easily have turned out to be worth less than what she paid for it, that this interest subjected her to personal liability for the debts of the enterprise, and, more important, that it was Scharpf, not Rogers, who pressed for the transfer of the business to the partnership (*supra*, pp. 10-12).[16]

However, we respectfully decline the invitation to become involved in any argument concerning family partnerships. As we have emphasized above (*supra*, pp. 6, 24-25), the present case does not concern the proper allocation

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[16]It may be noted that the Tax Court's decision in the instant case was prior to the remand to the Tax Court by the Supreme Court of the family partnership case of *Commissioner v. Culbertson*, 337 U.S. 737.

of the earnings of the partnership among the respective partners, but the wholly different question of whether such earnings can be taxed to petitioner. To the latter question the former is irrelevant. This is clear in principle and has been implicitly so regarded in every other decision which we have found. The Commissioner has zealously preserved the question of whether Rogers and Scharpf can be taxed upon the shares of the partnership's earnings distributable to their respective wives by serving appropriate deficiency notices upon them (*supra*, pp. 18-19). This action the Commissioner has taken although his theory in proceeding against Rogers and Scharpf is necessarily inconsistent with his theory here in attempting to allocate the earnings of the business *to petitioner* and therefore adversely reflects, *pro tanto*, upon the validity of his position before this Court.[17]

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[17]As demonstrated by the following computation for the year 1944, the Commissioner, by concurrently pursuing contradictory theories, seeks to collect substantially 100% of the combined net income of petitioner and the partnership:

			Amount
	Income:		
	Taxable income of petitioner (R. 18)		$ 559.42
	Taxable income of partnership (R. 31, Pet. Exh. 5)		66,119.33
			$66,678.75
	Federal income taxes asserted:		
	As to petitioner (R. 19, 326):		
	Income tax previously paid	$ 139.85	
Deficiencies asserted	Income tax	4,532.68	
	Declared value excess profits tax	6,565.25	
	Excess profits tax	24,562.88	$35,800.66
Amounts include deficiencies asserted	As to partners (R. 199, 200, Pet. Exhs. 41, 42, 43, 44):		
	John J. Rogers	$15,382.89	
	Louis C. Scharpf	15,459.50	$30,842.39
	Total tax asserted on above income		$66,643.05
	Recapitulation:		
	Taxable income (above)		$66,678.75
	Taxes asserted (above)		66,643.05
	Excess of income		$ 35.70

In reallocating the wives' shares of partnership income to their husbands, the Commissioner undertook to refund to the wives the

The point, in any event, is that any question of the proper allocation of the partnership's earnings among the four partners must remain open for decision on another day and in another case, to which Rogers and Scharpf, respectively, are parties. The issue in the present case is not whether the income of the partnership is taxable entirely to two of the four partners; it is whether the income of the partnership is taxable *to the corporation.* The Tax Court judge evidently thought of this case as a family partnership case, and thus was led to decide it on an issue not before him.

B. CASES DEALING WITH SIMILAR FACT SITUATIONS.

We have examined the controlling body of law in considerable detail under A, *supra,* partly because of the scarcity of cases dealing with an attempt to impute to a corporation the income of a separate business under facts even remotely similar to those of the instant case. The few pertinent cases which have been decided hold for the taxpayer; and, as we shall see, in various respects some of these cases present circumstances which might seem more favorable to the Commissioner than anything in the present case. On the other hand, the cases which have gone for the Commissioner are so far afield as to require scant attention.

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tax each had paid upon her share of such income (R. 197-198, Pet. Exhs. 38, 39). The taxes paid by the wives and thereafter refunded to them accordingly cancel out; these amounts are not included within and do not affect the above computation.

Assuming that the limitation period has not run, Rogers and Scharpf may file claims for refund and contest the .Commissioner's allocations of the wives' partnership incomes to them, but only in further proceedings with their attendant expense and delay.

Ross v. Commissioner, 129 F.2d 310 (5th Cir.), involved an attempt by the Commissioner to impute to a corporation the earnings of a partnership conducted by its stockholders. The corporation was engaged in the business of selling horses and mules at auction, on commission, at the same time that the partnership was engaged in the business of buying and selling horses and mules for its own account. The four partners worked at the same time for the corporation, without separation of their working hours; in this and other respects the business of the corporation and the partnership were entangled in a manner wholly lacking in the present case. Reversing the Tax Court, the Fifth Circuit held for the taxpayer on the fundamental proposition that the earnings of the partnership were produced by it. The Commissioner did not petition for certiorari.

Epsen Lithographers, Inc. v. O'Malley, 67 F. Supp. 181 (D. Nebraska), is in many respects similar on its facts to the present case. A father and elder son owned all of the stock of the taxpayer-corporation, which for several years had conducted a lithographing business. The corporation withdrew from the business and leased to a partnership, composed of the father and son, this son's wife, and two other sons, all of its physical property, equipment and machinery. The partnership took over the name formerly used by the corporation and thereafter conducted the business. Refusing to allocate the income of the partnership to the corporation, the court pointed out that the income in question was produced in fact by the partnership, through the efforts of the partners. The Government did not appeal.

In *Seminole Flavor Co.,* 4 T.C. 1215, the corporation had previously manufactured, advertised, sold and supervised the bottling of its flavored extracts. Thereafter, it continued the manufacturing end of the business, but the advertising, merchandising and supervisory services were handled under contract by a partnership composed of its stockholders, whose interests in the partnership were identical with their stock interests in the corporation. The Tax Court agreed with the Commissioner that (p. 1233) "Whether any such business agreement would have been entered into by petitioner [the corporation] with total strangers is wholly problematical." The court nevertheless held for the taxpayer on the ground that the earnings of a separate business were involved. The Commissioner did not appeal.

Buffalo Meter Co., 10 T.C. 83, involved a corporation which continued to conduct a foundry business but transferred to a partnership, composed of its stockholders, the manufacturing and selling division of the business. The court refused to allocate the earnings of the partnership to the corporation, and the Commissioner did not appeal.

Similarly, *Miles-Conley Co.,* 10 T.C. 754, affirmed as to another issue, on taxpayer's appeal, 173 F.2d 958 (4th Cir.), involved a corporation engaged in the produce business, which, while continuing to engage in the remainder of the business, transferred its dealings in vegetables to its controlling stockholder. This stockholder handled the vegetable business as a sole proprietor, sharing rented space and other facilities with the corporation and also sharing the services of certain of the corporation's em-

ployees. Holding for the taxpayer-corporation, the court said, in part (p. 762):

> "Respondent contends that the instant case can be distinguished from *Seminole Flavor Co., supra,* in that the sole proprietorship of Carlisle Miles & Co. was not organized and operated for a definite business purpose. As we have pointed out, respondent does not deny that A. Carlisle Miles, a living individual, organized and operated a business under the name of Carlisle Miles & Co. with his own money and his own efforts. It is not suggested that A. Carlisle Miles, doing business as Carlisle Miles & Co., should be disregarded as a sham. While it is difficult to follow the argument on this point, it seems to be respondent's position that no business purpose of the corporation was served by reason of its relinquishment of a part of its business and its permission to its sole stockholder to conduct the business thus relinquished in his individual capacity, that it will therefore be considered that the corporation did not relinquish any part of its business, and that when A. Carlisle Miles purported to carry on the part of the business purportedly relinquished he was doing so only as an agency or department of petitioner.
>
> "In our opinion this position does not represent a realistic appraisal of the facts. It ignores what was done and relies too much on what might have been done, or what should have been done."

The Commissioner did not appeal.

We particularly commend to this Court the opinion in the *Miles-Conley Co.* case, which precisely analyzes the body of law discussed under A, *supra,* and faithfully applies it to the facts.

The *Miles-Conley Co.* and *Buffalo Meter Co.* cases were both reviewed by the full Tax Court. Because of this, as well as the reasoning of their opinions, these cases command greater persuasive force than does the opinion and decision of the single judge in the present case. Indeed, in the light of these two cases, both decided as recently as 1948, it is difficult to believe that the full Tax Court, on review, would have countenanced the present decision.[18]

It is not to be supposed that the Commissioner's effort in the present case to allocate to a corporation the earnings of a partnership forms a piece of any consistent pattern of governmental activity in tax cases. Taxwise, there are advantages and disadvantages in doing business either in corporate or partnership form. A corporation pays corporate taxes, but its earnings are not taxable to its shareholders until distributed to them. A partnership pays no partnership taxes, but its net earnings are taxable to its partners in accordance with their respective shares whether or not such earnings are distributed to them.[19] This means that in some cases, unlike the instant case, the Government's tax collections will be increased by attributing the earnings of the business to a partnership or sole proprietorship rather than to a corporation. Such a case was *Paxson v. Commissioner,* 144 F.2d 772 (3rd Cir.), wherein the Commissioner, with the approval of the Tax Court, sought to tax to an individual, the general manager of the corporation, what in substance were the earnings of the corporation. Reversing the Tax Court,

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[18]There are other Tax Court cases holding for the taxpayer, some of which are cited *infra,* p. 49.

[19]Section 181, Internal Revenue Code, 53 Stat. 69, 26 U.S.C. Sec. 181.

the Third Circuit applied the same test employed in the cases just considered.

The cases holding for the Commissioner can be disposed of summarily. The single judge apparently considered *R. O. H. Hill, Inc.*, 9 T.C. 153; *Forcum-James Co.*, 7 T.C. 1195; and *Broadway Strand Theatre Co.*, 12 B.T.A. 1052, most closely in point, for these are cited in his opinion (R. 282).[20] *R. O. H. Hill, Inc., supra,* was a flagrant case in which the stockholders attempted to appropriate to themselves, as partners, the earnings of the corporation's most profitable business line, the printing of "E" award programs. The partnership had no office, no telephone, etc. The rationale of the case and its remoteness from the facts of the instant case are adequately shown by the following from the Tax Court's opinion (9 T.C. at p. 157):

> "The record shows clearly that the partnership contributed absolutely nothing either in services or capital to the production of the income arising from the executing of orders for 'E' award printing. Its capital was $150, which was little more than half of the amount expended in attorney fees for the work incident to the technical creation of a partnership and its contract arrangement with petitioner. It obtained no business, bought no supplies, and did no work. It is clear to us that its function and purpose were merely to siphon off the greater portion of the earnings derived by the petitioner."

Likewise, *Forcum-James Co., supra,* involved a partnership which had no offices of its own, no employees and did

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[20] In addition, the opinion cites for comparison *Ingle Coal Corporation*, 10 T.C. 1199. That case held certain payments to shareholders to be a distribution of profits and not deductible as royalties.

no work. Such books as it had were kept by the corporation; the income of the excavation project involved was patently that of the corporation. And *Broadway Strand Theatre Co., supra,* was similarly transparent. The theatre business was conducted by the corporation rather than by its controlling stockholder as an individual. Indeed, the corporation's own witnesses testified that the corporation was continued in order to hold the theatre lease and to protect the controlling stockholder against personal liability.

This concludes our discussion of the cases holding for the Commissioner which were cited in the Tax Court's opinion.

Several of the cases cited above contain discussions of the application of Section 45, Internal Revenue Code, 53 Stat. 25, as amended by the Act of February 25, 1944, 26 U.S.C. Section 45, which provides as follows:

> "In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Commissioner is authorized to distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses."[21]

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[21]The Act of February 25, 1944, Title I, Sec. 128(b), 58 Stat. 48, cited to text, amended this section by striking out "gross income or deductions" and inserting in lieu thereof "gross income, deductions, credits, or allowances."

We, therefore, briefly consider the application of this section to the present case.

At the opening of the hearing in the present case the trial counsel for the Commissioner said (R. 28):

> "The determination in this case is not predicated upon Section 45 of the Internal Revenue Code, which relates to the election as between one taxable entity and another, and certain items of income and certain items of deduction in order to determine the true income. The determination here is that the alleged partnership is without substance and should be disregarded, and therefore there is no taxable entity for the purpose of recognition, or the application of the provisions of Section 45."

Counsel immediately added (R. 28), "However, I did not mean to undertake, if I could, to waive any provision of Section 45 or any other section of the Code * * *."

Similarly, the Tax Court did not invoke Section 45 in reaching its determination (R. 284); as previously indicated, it cited Section 45, for the purpose of excluding that section, and cited no other statutory provision.

The Commissioner's trial counsel at the hearing, in the language quoted above, correctly pointed out that Section 45 subsumes the existence of two or more separate entities, recognized as such in administering the revenue laws. See *Ross v. Commissioner,* 129 F.2d at p. 313; *Seminole Flavor Co.,* 4 T.C. at pp. 1231-1232; and *Miles-Conley Co.,* 10 T.C. at pp. 761-762. On the contrary, the Commissioner's theory in the present case, as approved by the Tax Court, is that the partnership does not exist and is to be wholly disregarded for tax purposes.

For these reasons and others, which it is unnecessary to discuss, Section 45 is not further argued in this case.

C. APPLICATION OF THE LAW TO THE FACTS.

The issue in this case is a simple one—whether A is to be taxed on B's income. The corporation and the partnership here involved were separate and distinct entities, each having a genuine and real existence. The income of the business was produced by the partnership, it belonged to the partnership, and it was not factually or legally income of the corporation.

This is not a case like *Gregory v. Helvering, supra,* where a new entity was brought into transitory existence for the sole purpose of creating an appearance differing from reality—a mere sham and fraud, disappearing as soon as its object of concealment and deception was served. The partnership here actually purchased and took over the business, actually conducted it and is still conducting it.

Nor is this a case like *Lucas v. Earl, supra,* where a taxpayer attempted to assign or attribute income to someone other than the real producer thereof. The income here was produced by the partnership—by the exertions of its members and the use of its property.

This case involves a very common type of transaction—the conversion of a business from the corporate method to the partnership method of operation. Hundreds of corporations are converted into partnerships every year. Other hundreds of partnerships are converted into corporations. No one has ever supposed that such transactions were to be disregarded for tax purposes.

The present case differs in no material respect from a host of such every day conversions. If the corporation here had been completely liquidated and dissolved, certainly no one could have been taxed except the partners. If the corporation had transferred *all* its assets to the partnership, but had remained in existence as an empty shell, the same answer would surely follow. If the corporation transferred all assets except real estate, and continued to exist only for the purpose of holding that real estate, what possible reason is there for a different answer? It would be a strange rule of law that would require taxpayers, in converting a business from corporate to partnership operation or vice versa, to transfer all assets to the new entity and retain none in the old. There is no such rule, and there is no decision, basing tax consequences on any such arbitrary and senseless distinction.

What, then, led the Tax Court judge to decide the case as he did? In analyzing his opinion, we find that he appears to have been influenced chiefly by two factors: first, that the business conducted by the partnership was in many respects similar to the business conducted by the corporation (R. 278-282), and, second, that the income of the partnership was distributable differently from the income of the corporation (R. 283-284). Let us consider each of these factors.

First, as to the similarity between the business as conducted by the corporation and as conducted by the partnership. As the judge points out in his opinion, in general the business was conducted with the same assets and by the same people after it was transferred to the partnership as before. The business was also conducted under

the *former* name of the corporation. This is the normal state of affairs when a business is changed from corporate to partnership operation or vice versa. No court has ever held before that such similarity before and after the conversion should result in disregarding the conversion for tax purposes.

In actual fact, the differences between the corporation and the partnership here were *greater* than in the normal case. There was the usual difference that the stockholders, whose liability had been limited, assumed the unlimited liability of partners. But there was also the difference that $8,000 of additional capital was contributed, being the approximate amount of the average borrowing requirements. There was the difference that the wives, who had previously performed no services, began to perform some services, however "negligible." There was the difference that Mrs. Rogers, who had no interest in the corporation, became a partner, entitled to one-fourth of the profits if the business was successful, but also subjecting her personal holdings to unlimited liability for losses if it was not. There was the difference that Mr. Scharpf, who previously had a minor interest in the profits, now had a substantial interest, which was one of the things he wanted when he began to urge the formation of the partnership. And there was the difference that Mr. Scharpf now had the means of getting his investment out whenever he wished, which was the other thing he wanted.

If differences were necessary between the corporate operation and the partnership, there were plenty of differences. But no differences were necessary. We could stand flatly on the proposition that partners may incorpo-

rate their business, and the stockholders of a corporation may convert its business to a partnership operation, without *any* difference other than those inherent in the two different forms of business organization.

Second, the judge stressed the fact that the income of the partnership was distributable in a different manner than the income of the corporation. The judge thought this was a "bad" factor, which seems inconsistent with his other theory that there should have been more difference between the corporation and the partnership. Here was a very important difference: there was one partner who had not been a stockholder, and the proportionate interest of every partner was different from his proportionate interest as a stockholder. Ordinarily a court would regard such differences as making it difficult if not impossible to ignore the separate entities of the corporation and the partnership. But the judge below actually assigned it as a reason, and probably his most important reason, for ignoring the separate entity of the partnership.

Why did the judge below draw this unusual conclusion? It was evidently because he was mistakenly thinking of this case as a family partnership case.

Prior to the Supreme Court's recent decision in *Commissioner v. Culbertson,* 337 U.S. 737, the courts had gone to great lengths in denying tax recognition to family partnerships, i.e., in taxing the income of such partnerships entirely to the husbands if the wives contributed no significant capital or services. The language which the courts used in these cases was similar to that used by the judge below throughout his opinion: no change in the manner of conducting the business, no new capital, no

services or "negligible" services rendered by the wives, reallocation of income within family groups, and so on.

Since the judge below rendered his decision, the Supreme Court in the *Culbertson* case has caused a shift in emphasis, and has said that family partnerships are to be recognized for tax purpose if the parties had a *bona fide* intent to form a partnership. But that is not the point here. This is not a family partnership case. The issue here is not whether the partnership income is to be taxed entirely to the husbands or taxed partly to the wives; it is whether it is to be taxed *to the corporation.*

The judge below decided this case on the rationale of old family partnership decisions which are no longer the law. But when they were the law, the issue with which they were concerned was an issue foreign to this case. The husbands and wives are not parties to this case, and it does not matter here which of them are taxable on the income. The only issue in this case is whether the income is taxable to the corporation.

Except for his references to reallocation of income among family groups, the judge below made no comment as to any tax saving motive, and could have made none consistently with the record. The uncontradicted evidence is to the effect that tax saving played no part in the formation of the partnership, that its formation had been discussed long before the adoption of the excess profits tax law and at a time when the earnings of the business were such as not to make a tax saving likely, and that it was the result of Mr. Scharpf's desire for a change in his status.

But if tax saving had been one of the motives, that would be immaterial where, as here, there was a genuine and unequivocal transfer of the business to the partnership. That is made clear by many decisions of this and other courts, climaxed by Mr. Justice Black's recent expressions in the *Cumberland* case, *supra.*

The single judge made no finding of ultimate fact adverse to petitioner but in his opinion sought to characterize and comment upon certain segments of the uncontradicted evidence. In this connection, the single judge commented that petitioner's business, as conducted prior to 1941, "was unitary in character" (R. 282). This observation was made in an effort to distinguish the *Miles-Conley Co., Buffalo Meter Co.* and *Seminole Flavor Co.* cases, *supra.* Apparently, the judge was here taking the view that, as a matter of law, "unitary" business cannot be divided between a corporation and a partnership, and that the lumber and building supply business is such a unitary business. But there is no such proposition of law, and the *Broadway Strand Theatre Co.* case, *supra,* cited by the court, does not, as we have seen, so hold.[22] Moreover, as a matter of fact, the present business was not divided between petitioner and the partnership, but was wholly

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[22]In addition to the divisions of the businesses involved in the cases cited, *supra*, pp. 37-39, reference may be made to *Fair Price Stations, Inc.*, 5 T.C.M. 401, decided May 23, 1946 (corporation retained gasoline distribution franchise, partnership operated retail gas station); *Barq's Bottling Company,* 5 T.C.M. 505, decided June 21, 1946 (corporation continued to manufacture products, partnership sold them); and *Standard Fruit Products Co.,* 8 T.C.M. 733, decided August 22, 1949 (regular merchandise manufactured by corporation, inferior merchandise by partnership).

transferred to the partnership, and any finding to the contrary, if made, would be clearly erroneous.

We have here, then, the case of a *bona fide* transfer of a business out of the corporation's hands, with the income in question earned through the individual efforts of the partners and their employees and the credit and property of the partnership. The Tax Court made no ultimate findings of fact to the contrary, and any such finding or findings, if made, would have been clearly erroneous. Instead, the Tax Court applied to the uncontradicted facts an erroneous legal yardstick, the measure of which even its own opinion does not fully disclose. To what course the Tax Court would have been driven had petitioner dissolved in 1941, or what legal standard it believes should have been satisfied, the opinion leaves largely to conjecture.

Concluding our discussion of this topic, the present case is not one in which there was any sham or unreal transaction, or any transitory creation of a fictitious entity. It is not a case in which income earned by one entity has been returned as that of another. It is not a family partnership case. It is simply a case in which a business has been converted from a corporate to a partnership method of operation, with such incidental changes in the rights of the parties as they desired or the law implied. There is no reason why this conversion should not be given the same recognition for tax purposes as has been accorded without question to hundreds of similar conversions that take place every year.

II.

The Tax Court Erred in Failing to Include, When Computing Petitioner's Excess Profits Credit for 1943 and 1944, the Invested Capital and Accumulated Earnings and Profits of the Partnership as of the Beginning of Each of These Taxable Years.

As previously mentioned, the Court will not reach this point unless it holds for the Commissioner on Point I. In that event, however, the Court will then need to consider the method approved by the Tax Court in computing the excess profits credits to which petitioner would be entitled for the years 1943 and 1944. Our position is that the Tax Court compounded its first error by attributing the earnings of the partnership to petitioner but denying it the credits against such income to which it would be entitled if such earnings belonged to it.

A. THE ERROR IN COMPUTING THE CREDITS.

As a consequence of a determination that the partnership's earnings were to be attributed to petitioner, the latter would become liable for the wartime excess profits tax imposed during the years in question by Section 710, Internal Revenue Code. This section imposed a very high tax upon the "adjusted excess-profits net income" of corporations, amounting, in petitioner's case, to about 90% of such income for the years 1943 and 1944.

The scheme of Section 710 and the succeeding sections was to compute the amount of income subject to the excess profits tax by subtracting from the total net income the amount of earnings Congress deemed to be a taxpayer's normal and fair return. This deductible amount, called the excess profits credit, was to be computed in

one of two ways, whichever resulted in the lesser tax. Section 712. The first, not here involved, permitted deduction of an amount equal to the corporation's average net income for the taxable years 1936 to 1939, inclusive. Section 713. The second, employed here, permitted the deduction of an amount equal, so far as this case is concerned, to 8% of the corporation's invested capital for the taxable year. Sections 714-720. *An includible element of the "invested capital" was the accumulated earnings and profits as of the beginning of the taxable year.* Section 718(a)(4).[23]

It will therefore be seen that, in imposing this severe tax, the Congress took pains to provide appropriate credits. Manifestly, the burden of this tax is magnified out of proportion to the Congressional scheme if full effect is not given to the credit provisions.

The Tax Court's decision (R. 325-326) established deficiencies against petitioner in the exact amounts asserted by the Commissioner in his deficiency notice of October 3, 1947, excepting only the matter of penalties (R. 12). This means that reference to the deficiency notice will clarify the manner in which the excess profits credits were computed for the purpose of the Tax Court's decision.

The Commissioner proceeded, first, by attributing to petitioner the income of the partnership, in the amounts of $42,086.52 for 1943 and $66,002.66 for 1944 (R. 14).

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[23]The foregoing summary of the excess profits tax provisions accords with the Court's summary in *Commissioner v. South Texas Co.*, 333 U.S. 496, 497.

In *John Breuner Company v. Commissioner*, decided January 25, 1950, this Court has recently considered the inclusion of accumulated earnings and profits in computing invested capital.

These amounts, it will be noted, were not the gross earnings of the partnership but its net earnings, before the "salaries" of the partners but after the salaries and wages of its employees, the cost of goods sold and other appropriate deductions (R. 31, Pet. Exh. 5). The Commissioner then deducted from the amount so transferred to petitioner $13,200 for each year, representing the salaries of Rogers and Scharpf, as well as, for 1944, a further minor item (R. 14). It will be seen that the resulting amounts of $28,886.52 for 1943 and $52,302.35 for 1944 (R. 14) were then carried into the computation of petitioner's excess profits net *income* for each year (1943—R. 15, 17; 1944—R. 18, 19). So far, the computation proceeds logically to follow the Commissioner's theory, as approved by the Tax Court. At the same time, however, in computing the excess profits *credits* this logic is abandoned. For 1943 the excess profits credit was computed with reference only to the par value of petitioner's stock and two minor items derived from petitioner's balance sheet (R. 17). And for 1944 the credit was based solely upon the par value of petitioner's stock (R. 19). The Commissioner, and the Tax Court, entirely disregarded any portion of the partnership's invested capital and accumulated earnings and profits, although it was these, together with the work of the partners and their employees, which had generated the very income upon which the excess profits tax was computed.

Petitioner filed in the Tax Court, prior to the entry of decision, its own computation of the taxes due under the court's opinion (R. 291-307). A reference to this computation further demonstrates the error in the decision as

entered. Petitioner's computation of the credits for the two years is obtained by including, among other items, $8,000 for each year, representing the initial investment in the partnership, and $23,356.62 for 1943 and $52,100.27 for 1944 (R. 302). The two amounts last mentioned are obtained by consolidating the balance sheets of petitioner and the partnership, and including within the invested capital of the consolidated entities the net earnings of the partnership, except the salaries paid to Rogers and Scharpf (R. 301). The amounts represent, respectively, the accumulated earnings and profits at the beginning of each of the taxable years. The respective computations result in a substantial difference in taxes (compare R. 326 with R. 293).

We submit that the Commissioner's computation, as approved and entered by the Tax Court, is oppressively unfair and is wholly without statutory warrant. Section 710 commences by imposing the tax upon the "adjusted excess-profits net income * * * of every corporation," with exceptions immaterial here. The Commissioner's theory in the present case, as approved by the Tax Court, appears to be that petitioner and the partnership are to be treated as a single taxable entity. Therefore, in imposing the tax, the Commissioner and the Tax Court read "every corporation" to mean every "taxable entity." The same logic requires them to give "corporation" and "corporations," as they appear in Section 712(a), relating to the excess profits tax credit, exactly the same meaning.

It would appear that the Commissioner's position has not been consistent on this basic question. *R. O. H. Hill, Inc., supra,* was, as we have seen, a flagrant case where the

partnership was rightfully disregarded. In that case, however, for the purpose of computing the corporation's income, declared value excess profits and excess profits taxes, the Commissioner had refused to allow as deductions additional compensation paid, purportedly by the partnership, to various employees of the corporation whose services had largely contributed to the production of the income. The Commissioner argued that this compensation was not deductible as an expense because the recipients of the payments were not employees of the partnership. The Tax Court answered this argument as follows (9 T.C. at pp. 158-159):

> "We think this argument is inconsistent with respondent's position that the partnership should be disregarded. We have held that the partnership was really the petitioner and that its income was that of the petitioner. It necessarily follows that its disbursements were those of the petitioner and these payments of additional compensation to employees, which are indicated by the record to be reasonable in amount, should be allowed as deductions to petitioner."

We submit, therefore, that the Tax Court erred in excluding from the computation of the excess profits credit the invested capital and accumulated earnings and profits of the partnership. Other errors in the computation as entered we do not detail. In fact, Commissioner's counsel, although afforded the opportunity, made no detailed analysis or criticism of petitioner's contrary computation (R. 314-324). Decision should have been entered in accordance with petitioner's computation (R. 293).

B. PETITIONER DID NOT WAIVE A CORRECT COMPUTATION OF ITS TAXES.

The Tax Court refused to decide the foregoing questions involved in a correct computation of the deficiencies resulting from its holding that the partnership income was to be attributed to petitioner. Without marshalling the pertinent facts or citing any authority, the single judge did enigmatically comment (R. 326):

> "We are not impressed by the argument that profits credited to the individuals who were petitioner's stockholders have the character of accumulated earnings of the corporation under a holding denying recognition to the partnership."

However, the Court immediately proceeded (R. 326):

> "But as no issue was raised in the pleadings as to the computation of taxes under respondent's determination that the partnership should not be recognized, none may be now raised and decided under Rule 50 [Rules of Practice before the Tax Court of the United States]."

The pertinent procedural facts in this connection are as follows: Following service of the deficiency notice of October 3, 1947 (R. 10-19), petitioner filed its petition in the Tax Court, alleging facts upon which it relied (R. 7-9) and including in its assignment of errors the allegation that the "Commissioner erred in computing excess profits taxes on the net income of petitioner for the years 1943 and 1944 * * * in the amounts set out in Exhibit A [the deficiency notice], or in any other amounts" (R. 6, para. 4(f)). Following a denial of the allegation last mentioned, in the Commissioner's answer (R. 20, para. 4), the parties at the hearing developed pertinent facts cov-

ering the initial investment in the partnership and its accumulated earnings and profits, Commissioner's counsel cross-examining at length on certain of these matters (*supra*, pp. 13-14; note particularly R. 31, 118-120, 152-155, Pet. Exh. 6).

Thereafter, the court entered its findings of fact and opinion, holding that for tax purposes the partnership was to be disregarded, and concluded its opinion with the statement (R. 284):

> "Decision will be entered under Rule 50."

Following denial of petitioner's motion for review and reconsideration by the full court (R. 4), the parties filed their respective computations of the deficiencies established by the court's holding (Commissioner's computation—R. 286-290; petitioner's computation—R. 291-313). A hearing on the computation was then held by the single judge (R. 314-324). Without independently considering the correct computation of the deficiencies, his decision followed, entering the deficiencies set out in the original deficiency notice, as recomputed by the Commissioner with the elimination of the penalties (R. 12, 287, 326). The reasons given for this extraordinary disposition of the matter were those set out at the beginning of this discussion, *supra*, p. 56.

Clearly, the petitioner was entitled to a hearing on the correct computation of its taxes. This was a right of which neither statute nor rule could deprive it. If the Commissioner now attempts to support the action of the Tax Court, it must be on the ground that in some fashion petitioner waived or abandoned its right to such a computation. Such a waiver or abandonment is certainly not

to be presumed; we submit that the above review of the procedural facts affirmatively shows that there was no such waiver or abandonment.

Rule 50 of the Tax Court's Rules did not put petitioner on notice of any action which it should have taken other than the course followed.[24] The gist of Rule 50, for pres-

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[24] "RULE 50.—*Computations by Parties for Entry of Decision*

"Where the Court has promulgated or entered its opinion determining the issues in a proceeding, it may withhold entry of its decision for the purpose of permitting the parties to submit computations pursuant to the Court's determination of the issues, showing the correct amount of the deficiency or overpayment to be entered as the decision. If the parties are in agreement as to the amount of the deficiency or overpayment to be entered as the decision pursuant to the report of the Court, they or either of them shall file promptly with the Court an original and two copies of a computation showing the amount of the deficiency or overpayment and that there is no disagreement that the figures shown are in accordance with the report of the Court. The Court will then enter its decision. If, however, the parties are not in agreement as to the amount of the deficiency or overpayment to be entered as the decision, in accordance with the report of the Court, either of them may file with the Court a computation of the deficiency or overpayment believed by him to be in accordance with the report of the Court. The clerk will serve a copy thereof upon the opposite party, will place the matter upon a motion calendar for argument in due course, and will serve notice of the argument upon both parties. If the opposite party fails to file objection, accompanied by an alternative computation, at least five days prior to the date of such argument, or any continuance thereof, the Court may enter decision in accordance with the computation already submitted. If in accordance with this Rule computations are submitted by the parties which differ as to the amount to be entered as the decision of the Court, the parties will be afforded an opportunity to be heard in argument thereon on the date fixed, and the Court will determine the correct deficiency or overpayment and enter its decision.

"Any argument under this Rule will be confined strictly to the consideration of the correct computation of the deficiency or overpayment resulting from the report already made, and no argument will be heard upon or consideration given to the issues or matters already disposed of by such report or of any new issues. This Rule is not to be regarded as affording an opportunity for rehearing or reconsideration."

ent purposes, is that the Tax Court when it enters its opinion "may," in an appropriate case, withhold entry of decision for the purpose of permitting the parties to submit computations showing the correct amount of the deficiency or overpayment resulting from the court's holding. If these computations differ, the parties are afforded an opportunity to be heard in argument thereon before the court. The scope of the hearing on the computation is implicit in the Rule and is expressly stated in its second paragraph. Argument under the Rule is to be strictly confined to the consideration of the "correct computation * * * resulting from the report already made"; such argument is not to deal with issues or matters already disposed of or of any new issues, and does not afford an opportunity for rehearing or reconsideration.

In the present instance, petitioner, of course, did not seek at the hearing on the computation (R. 314-324) a rehearing or reconsideration of matters already disposed of, or the consideration of any matter not directly relating to a correct computation under the court's prior holding.

Nor, we submit, can the Commissioner point to any settled practice or line of decisions which would justify the action of the Tax Court in the present case. This is not a case where petitioner had waived or abandoned any element of a correct computation; the naked question is presented as to the affirmative action which a taxpayer

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At the time the petition was filed in the instant proceeding, "a motion" in the fifth sentence of the first paragraph, as quoted above, read "the hearing." Effective December 15, 1948, Rule 50 was amended to its present form. For present purposes this change is immaterial.

must take to secure such a computation. Just a few months before the petition was filed in the instant proceeding, the Tax Court entered a decision involving, as it happened, excess profits taxes under Rule 50, which seems quite inconsistent with its action here. *Hardinge Company, Inc.,* 6 T.C.M. 650, decided June 13, 1947. That case presented the question as to whether, under Rule 50, the court could take into account an overpayment of income taxes which, if sustained, would wipe out a deficiency in excess profits taxes. In its petition to the court the taxpayer had alleged all pertinent facts but had not assigned as error the Commissioner's failure to allow a credit for or refund of the overpayment. The petition apparently did ask for a decision under Rule 50. Holding for the taxpayer and taking the overpayment into account, the court said in part (p. 651):

> "The point upon which the fact of overpayment depends is not the claim therefor in a petition timely filed but the facts set forth in such petition which if proved establish overpayment * * *. Petitioner did not state specifically in its petition that it claimed an overpayment but it asked for decision under Rule 50. That means that petitioner claimed whatever a computation in accordance with the established facts of the case showed it entitled to receive."

The petition in the present case is more explicit than apparently was the petition in the *Hardinge* case. The instant petition did not mention Rule 50, but the Tax Court itself invoked this rule in its opinion entered March 23, 1949 (R. 284). This was the obviously correct action on the part of the court, but it also tended to assure peti-

tioner that the deficiencies asserted against it would receive a full and fair review and that no immediate action by petitioner in the form of a motion to reopen the prior hearing or to amend its petition was necessary in order to obtain such a review.

We submit, therefore, that petitioner remains entitled, under the Tax Court's holding attributing the income of the partnership to petitioner, to a correct computation of the deficiencies in its taxes.

III.

The Scope of Review in Tax Court Cases.

By virtue of the 1948 amendment to Section 1141(a) of the Internal Revenue Code,[25] Tax Court decisions are now to be reviewed "in the same manner and to the same extent as decisions of the district courts in civil actions tried without a jury." This means that all issues of law are open for review and that, under Rule 52(a), Federal Rules of Civil Procedure, findings of fact are to be reviewed by application of the "clearly erroneous" test. See *Grace Bros. v. Commissioner,* 173 F.2d 170, 173-174 (9th Cir.). The review under the "clearly erroneous" test is to be contrasted with the narrower scope of review under the "substantial evidence" test, which is applicable to jury verdicts and the findings of certain administrative agencies (*Labor Board v. Columbian Co.,* 306 U.S. 292, 300). Contrasting the "clearly erroneous" test with the latter test, the Supreme Court has observed that in the

[25]Section 1141(a), Internal Revenue Code, 53 Stat. 164, as amended by Section 36 of the Act of June 25, 1948, 26 U.S.C., Supp. II, Sec. 1141(a).

latter case, "the review is much more restricted." *District of Columbia v. Pace,* 320 U.S. 698, 702.[26]

"A finding is 'clearly erroneous' when *although there is evidence to support it,* the reviewing court on the entire evidence is left with the definite and firm conviction that a mistake has been committed." (Italics ours). *United States v. United States Gypsum Co.,* 333 U.S. 364, 395.

The present is not a "fact" case, and we include this brief reference to the scope of review primarily for completeness of our discussion. Here, the Tax Court rather clearly demarked its findings of fact from its application of what it conceived to be the law to the facts. The critical error of the Tax Court is to be found in its application to the uncontradicted facts of an erroneous concept of the law, which included, as we have seen, giving weight to the internal organization of the partnership. Accordingly, this Court's review is essentially a re-examination of the applicable law, unencumbered even by the clearly erroneous test.

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[26]See Stern, "Review of Findings of Administrators, Judges and Juries: A Comparative Analysis," 58 Harv. L. Rev. 70, 80-89. At the cited pages, this article contrasts the "clearly erroneous" and the "substantial evidence" rules.

CONCLUSION

For the reasons discussed under Point I of the Argument, the decision of the Tax Court should be reversed. Should the Court find it necessary to consider Point II of the Argument, then, for the reasons therein discussed, the case should be remanded to the Tax Court for a correct computation of the tax deficiencies.

Respectfully submitted,

Herman Phleger,
Theodore R. Meyer,
Alvin J. Rockwell,
Carl E. Davidson,
Ralph R. Bailey,
Attorneys for Petitioner.

Brobeck, Phleger & Harrison,
Of Counsel.

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